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Top three trends in venture debt for 2017

As the bank regulatory environment continues to tighten, and the private credit markets expand, venture debt remains a go-to source of working capital for venture-backed growth stage companies. While the terms, players and investors have changed over time, venture debt remains a consistent presence in the venture capital and private credit markets, and we anticipate some interesting trends and challenges on the horizon.

Larger venture loans

While the tech IPO market continues to rebound and M&A activity moves along at a steady pace, valuations of emerging companies were down overall in 2016 (as was the rate of venture equity investing), making it harder for venture-backed companies to continue to raise capital at steadily higher valuations, if at all.

For most non-"unicorn" venture-backed companies, raising equity capital was challenging in 2016. As a result, the market will likely see a rise in venture debt transactions. When valuations are pressured, or companies stall while heading towards an exit, investors and founders seek new debt or expanded facilities to provide additional working capital. As such, venture loan sizes are likely to increase as more mature borrowers work towards exit. In turn, the market should expect the term of later-stage loans to be expanded to provide for a longer path to liquidity. As such, given the increased size and maturity of later-stage loans, venture debt lenders will need to syndicate or participate interests in transactions in order to meet these demands.

Focus on fundamentals, venture lenders step in

Commensurate with larger loans and longer maturity, we may see a greater emphasis on the value and integrity of collateral, the inclusion of more financial covenants, an increased focus on the caliber of a company's management, requirements of interim capital infusions and of course, requirements for additional equity kickers for the lenders. In addition, to the extent banks reassess their lending policies or exit matured credits — or borrowers look to replace early stage bank lines that have become unmanageable for compliance reasons (or borrowers simply mature out of such credits) — private venture lenders will likely step in. Given the various market factors of longer exit cycles, challenged valuations and some uncertainty in the bank regulatory environment, private venture debt transactions should be poised for growth in 2017.

Venture lenders expand their capital options

Of course to source the capital necessary to meet these opportunities, venture lenders will need to expand beyond traditional limited partnership structures. Venture lending funds may look to use SBIC/SBA leverage structures to expand their capital base or obtain capital from feeder funds and backup finance funds, which provide uncommitted but ready sources of additional capital. Funds may also look to large family offices as capital providers or co-lenders, where family offices desire increased returns from alternative asset classes but cannot themselves source or manage a portfolio of growth capital loans. Finally, the market may see the launch of new business development corporations that can offer liquidity to investors in lieu of traditional partnership structures where capital can be called and tied up over multi-year periods.

In sum, 2017 should provide a great opportunity to venture firms and venture banks to provide debt financing to growth and later-stage venture-backed companies; the challenge will be to source the capital to do so. Nonetheless, venture loan activity should continue to be a growing segment of the private credit market in 2017.

Jennifer Post has deep experience in the venture capital industry, and works on fund formations, portfolio transactions and venture equity and lending transactions in key venture communities including Boston, the Bay Area and Los Angeles. Jennifer can be reached at jpost@thompsoncoburn.com or by telephone at 310 282 2512.

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